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DEPARTMENT OF THE TREASURY
BEFORE THE HOUSE WAYS AND MEANS COMMITTEE

Mr. Chairman and Members of the Committee:

I am pleased to appear before you today to discuss the tax provisions of the President's Fiscal Year 1998 budget. The President's plan would provide targeted tax relief, promote a fairer tax system and encourage activities that contribute to economic growth, while achieving a balanced budget by Fiscal Year 2002. We look forward to working with all the Members of this Committee to accomplish these goals.

We are especially pleased that, following this overview of the tax provisions of the budget, the Committee is having this hearing today to focus on education issues. The President's FY 1998 budget plan contains a number of proposals to promote education. In particular, the President has offered several tax proposals to encourage higher education and job training. We welcome this opportunity to discuss these proposals with you.

In addition to encouraging investment in education, the President's tax plan would provide tax cuts to working families, capital gains tax relief and simplification targeted to home ownership, and tax incentives to promote savings and to promote the hiring of the economically disadvantaged. Under the President's plan, the gross tax cuts would total $98.4 billion through FY 2002.[1]

The President's tax plan is also fiscally responsible. The budget offsets the costs of these tax cuts by making cuts in spending and by eliminating unwarranted corporate tax subsidies, closing tax loopholes that are not economically sound, and improving tax compliance. These measures produce budget savings of $34.3 billion through FY 2002. Reinstatement of expired trust-fund excise taxes under the President's tax plan will produce additional savings of $36.2 billion through FY 2002.

[1] The President's budget produces, without a sunset of the tax provisions, balance in FY 2002, under OMB assumptions. To ensure balance under CBO assumptions, the President's budget would sunset after FY 2000 the following tax provisions: the child credit; the HOPE scholarship tuition credit and tuition deduction; expanded IRAs (except in certain technical aspects); and the brownfields deduction.

Others have proposed higher tax cuts, but our commitment to balancing the budget and sound tax policy requires us to exercise restraint. As Secretary Rubin stated in testimony before this Committee on February 11, tax cuts that are much more costly than the President's proposals would require us to make cuts that are too deep in Medicare, Medicaid, education, the environment, or other priority areas.

Given the need for fiscal discipline, one of our principles throughout President Clinton's tenure has been that tax relief should be concentrated on middle-income taxpayers. In 1993, the Administration worked with Congress to cut taxes for 15 million working families by expanding the Earned Income Tax Credit (EITC), and to help small business by increasing expensing of capital investments and by providing targeted capital gains incentives. A year later, the President proposed his Middle Class Bill of Rights, including child tax credits, deductions for higher education, and expanded Individual Retirement Accounts. Then in 1996, he signed into law a number of other tax benefits for small businesses and their employees, as well as a new tax credit for adoption.

This year, the budget again proposes the President's Middle Class Bill of Rights, with a number of proposals aimed at helping middle-class families pay the bills, raise their children and send them to college, and save for retirement. This year, however, the plan goes farther. It includes more tax incentives and relief with regard to education and training, capital gains on home sales, work opportunities, and distressed areas, and provides employment and investment incentives to revitalize the District of Columbia.

Middle Class Bill of Rights

The President's Middle Class Bill of Rights focuses on middle-income taxpayers. It includes targeted tax incentives to encourage investment in education and training. It would immediately and significantly benefit families with young children, and promote long-term saving. When evaluating the extent to which the Administration's budget enhances educational opportunities, however, these proposals must also be considered in conjunction with the President's Pell Grant proposals, which give comparable education incentives for those persons who do not have a high enough tax liability to benefit from a non-refundable tax credit.

Education and Training Incentives. Well-educated workers are essential to an economy experiencing technological change and facing global competition. We believe that reducing the after-tax cost of education for individuals and families through tax credits and deductions would encourage investment in education and training while lowering tax burdens for middle-income taxpayers. There is widespread agreement that increasing the education levels of the U.S. work force is essential to a growing economy and an increasing U.S. standard of living. The ever-growing expenses of higher education, however, place a significant burden on many middle-class families.

The President's balanced budget plan contains tax incentives to assist families with the costs of postsecondary education. These incentives will encourage Americans of every age to pursue their education beyond high school so that they can compete effectively in the global economy of the next century and achieve a higher standard of living. Tax relief is provided to families of all kinds, whether they are saving to send a child to college, paying currently for a parent or child to attend college or graduate school, or hoping to lessen the burden of student loans. Tax benefits are available not only for undergraduate degree programs, but also for training to acquire or improve job skills. These tax proposals complement other proposals in the budget to increase access to higher education, such as the proposal to increase the maximum Pell Grant by $300 and to make more aid, including Pell Grants, more accessible to independent students with low income levels. In addition, the budget proposes to cut a variety of student loan fees.

The tax incentives are a key part of our agenda for higher education because they provide broad-based assistance, and they do not require more students to participate in the financial aid system. Also, by providing incentives to save for higher education, they can help families prepare for the cost of college, helping to reduce the demand for student aid.

The President's budget contains five specific tax proposals related to higher education. They are:

> ***HOPE Scholarship Tax Credits.*** Taxpayers would be able to claim a nonrefundable tax credit of up to $1,500 per year (indexed for inflation beginning in 1998) for two years to cover tuition and fees for themselves, their spouses, or their dependents while enrolled at least half-time in the first two academic years of a degree or certificate program. To take the credit in the second year, the student must have attained the equivalent of at least a B minus grade point average in course work completed before that year. No credit is available if the student has been convicted of a drug-related felony. Federal grants (but not loans or work-study payments) reduce the allowable credit. The credit is phased out for families filing a joint return with modified AGI between $80,000 and $100,000 (between $50,000 and $70,000 for single filers), indexed for inflation beginning in 2001. The credit would apply to course work beginning after June 1997.

> ***Education and Job Training Tax Deduction.*** As an alternative to the HOPE scholarship, taxpayers could elect to deduct up to $10,000 per year ($5,000 in 1997 and 1998) of tuition and fees for students enrolled at least half-time in a degree or certificate program, or for courses to improve job skills. The deduction can be claimed even by taxpayers who do not itemize. Unlike the HOPE Scholarship credit, which is calculated per-student, the deduction does not vary with the number of students in a family. The deduction is phased out at the same income levels as the HOPE Scholarship credit and would apply to course work beginning after June 1997.

These two provisions will help make 14 years of education the norm for all Americans. They would make a dramatic difference in family finances and are expected to help 12.3 million students in 1998 alone. In fact, middle-income families would be able to combine the tuition deduction with the President's proposal to allow penalty-free IRA withdrawals for education (or with a qualified state tuition program); in many cases, this would have the same effect as avoiding all income tax on college savings.

Tax-Free Employer-Provided Educational Assistance. We should also continue to encourage employers to provide educational assistance to their employees. Currently, up to $5,250 of tuition paid by an employer under a qualified educational assistance program need not be included in the income of the employee. However, the exclusion for undergraduate education expires in mid-1997, and the exclusion ceased to apply to graduate-level courses after mid-1996. The Administration strongly believes that the tax law should encourage employers that are willing to support employees' educations, including for those employees who have already graduated from college and who go back to school to develop new skills. The budget would reinstate the exclusion for graduate-level assistance retroactive to its prior expiration, and would extend both undergraduate- and graduate-level assistance through December 31, 2000.

Ten Percent Tax Credit to Small Businesses that Provide Educational Assistance to Employees. In addition, the Administration believes that an additional incentive is needed to foster increased educational opportunities and work-force training for employees of small businesses that otherwise may be unable to devote sufficient resources to their employees' skill development.

To address this concern, the budget proposes that for taxable years beginning after December 31, 1997, and before January 1, 2001, small businesses (employers with average annual gross receipts of $10 million or less for the prior three years) would be allowed a 10 percent income tax credit for payments for education of employees under an employer-provided educational assistance program. This proposal will help offset administrative costs of small businesses providing educational opportunities for their employees. It is projected to benefit 1.7 million employees.

Expanded Tax-Free Treatment for Forgiveness of Student Loans. The Administration believes in encouraging Americans to use their education and training in community service. Providing tax relief in connection with the forgiveness of certain student loans will help make it possible for students with valuable professional skills to accept lower-paying jobs that serve the public.
To this end, the budget eliminates the tax liability that normally arises when debt is forgiven, if the lender is a charitable or educational institution that lends money to

a student to pay for education and then forgives the loan after the student fulfills a commitment to perform community or public service at low pay for a certain period of time. The same tax-free treatment would also apply when the Federal government forgives a loan made through the direct student loan program for a student who has been making income-contingent repayments for an extended period.

$500 Child Tax Credit. Over the past decades inflation has reduced the value of the personal exemption, so the burden of taxes has shifted from smaller to larger families. A targeted child credit is an efficient way to address the increase in relative tax burdens faced by larger families. Under the Administration's budget plan, taxpayers would receive a $500 nonrefundable credit ($300 in 1997, 1998 and 1999) for each dependent child under the age of 13. The credit would be phased out for taxpayers with adjusted gross incomes (AGI) between $60,000 and $75,000. Beginning in 2001, both the amount of the credit and the phase-out range would be indexed for inflation.

The relief is directed to low- and middle-income taxpayers because of the limited resources available for tax reduction and higher-income taxpayers' relatively greater ability to pay current levels of income taxes. In the year 2000, this proposal will provide needed tax relief for over 17 million middle-income families. The credit would be nonrefundable, but working families would first deduct the child credit from their income taxes before deducting the refundable EITC -- making it easier for them to get the benefit of both credits.

Expansion of Individual Retirement Accounts. The Administration believes that individuals should be encouraged to save in order to provide for long-term needs, such as retirement and education. Tax policies targeted to middle-income taxpayers can provide an important incentive for generating new savings. (By contrast, new tax benefits for savings by upper-income people are more likely to result in shifting into tax-favored investments of savings that would otherwise occur.) The Administration's proposal would expand the availability of deductible individual retirement accounts (IRAs) to families with incomes under $100,000 and individuals with incomes under $70,000.[2] These thresholds, as well as the annual contribution limit of $2,000, would be indexed for inflation. As under current law, if an individual (and the individual's spouse) is not an active participant in an employer-sponsored plan, the individual (and spouse) would be eligible for a deductible IRA without regard to income.

Taxpayers would have the option of either deducting the amount deposited in an IRA account (and paying tax on the contributions and earnings when withdrawn), or forgoing an immediate deduction but not having to pay tax on either the contributions or earnings on the

[2] Beginning in 1997, eligibility would be phased out for couples filing joint returns with AGIs between $70,000 and $90,000 ($45,000 and $65,000 for single filers). Beginning in 2000, eligibility would be phased out for couples filing joint returns with AGIs between $80,000 and $100,000 ($50,000 and $70,000 for single filers).

contributions when the funds are withdrawn from a new Special IRA, provided the contributions remain in the Special IRA for at least five years. The purposes for which withdrawals could be made without early withdrawal tax would be broadened to include higher education costs, first-home purchases, and long-term unemployment.

Individuals with moderate incomes and younger people, who are now doing very little saving, should find the expansion of IRAs to meet a wider variety of savings needs, such as first-time home purchases and higher education expenditures, very attractive. This expansion also has a strong policy rationale. Homes frequently provide an important financial resource during retirement years, and education will improve productivity and economic security of the next generation. In addition, the knowledge that IRA assets are available to deal with possible family crises, such as unemployment, will make middle-income families more comfortable with beginning a commitment to IRA savings. Moreover, by dramatically increasing the number of middle-income taxpayers eligible for IRAs, financial institutions will have an increased incentive to advertise vigorously and to promote tax-preferred savings accounts. Widespread advertising and media attention to IRAs should be effective in increasing awareness of the importance of saving and encouraging IRA contributions, especially among moderate-income taxpayers.

Exclusion of Gains on Sale of Principal Residence. The budget provides substantial simplification and tax relief for millions of Americans by replacing the current-law tax treatment of capital gains on home sales with an exclusion of up to $500,000 of gain for married taxpayers filing joint returns ($250,000 for other taxpayers). The exclusion is available every two years, so long as the taxpayer used the house as a principal residence for at least two of the five years prior to the sale (the exclusion would be pro-rated for taxpayers forced to move in less than two years). The exclusion generally applies to sales on or after January 1, 1997.

The budget proposal would provide substantial simplification. Currently, all homeowners must keep detailed records of the original cost and improvements to their home because of the potential for capital gains tax liability, even though fewer than four percent of home sales result in taxable capital gains. Under the budget proposal, record-keeping burdens for income tax purposes would be substantially reduced for over 60 million households that own their homes. The number of taxpayers paying capital gains tax on residences would be reduced from about 150,000 per year to fewer than 10,000 per year (one-quarter of one percent of those selling their homes).

Under current law, capital gains from the sale of principal residences are subject to tax. However, taxpayers can postpone the capital gains tax by reinvesting in a replacement residence with a purchase price equal to or higher than the adjusted sales price of the house that is being sold. In addition, taxpayers age 55 and over can elect to take a one-time exclusion of up to $125,000 in gains on residences.

The current-law postponement of capital gain from the sale of a principal residence encourages some taxpayers to purchase larger and more expensive houses than they need because the purchase price of a new home must be greater than the sales price of the old home. Current law also may discourage some taxpayers from selling their homes. When taxpayers feel they must move to a less expensive home, because they are experiencing financial difficulty, going through a divorce, or for other reasons, they currently must pay tax on any gain on their home sale. The budget proposal would eliminate these problems in almost all cases.

Similarly, while the one-time capital gains exclusion has successfully relieved most taxpayers over 55 from tax liability on the sale of their homes, it contains certain tax traps for the unwary that can result in loss of the benefits of the current exclusion and significant capital gains taxes. For example, an individual is not eligible for the $125,000 one-time capital gains exclusion if the exclusion was previously utilized by the individual's spouse. This restriction has the unintended effect of penalizing individuals who marry someone who has already taken the exclusion. The budget proposal would eliminate these traps for the unwary.

Estate Tax Relief for Small Businesses and Farms

The budget proposes to ease the burden of estate taxes on farms and other small businesses, which may have a cash-flow problem when estate taxes must be paid after death. Under current law, estate tax attributable to certain closely held businesses may be paid in installments (interest only for four years, followed by up to ten annual installments of principal and interest). A special four-percent interest rate is provided for the tax deferred on the first $1 million of value. Only certain types of business arrangements are eligible for the installment payment provision, and a special estate tax lien applies to property on which the tax is deferred during the installment payment period. To take full advantage of the available tax benefits, an estate must make an annual filing using complicated interrelated computations to recompute the payment due each year.

The budget proposal would address the liquidity problems of estates holding farms and closely held businesses, and simplify the tax laws, by increasing the value cap on the special low interest rate from $1 million to $2.5 million, expanding the availability of these rules to other comparable business arrangements, and authorizing the Secretary to accept security arrangements in lieu of the special estate tax lien. The applicable interest rates would be cut by 50 percent or more, but interest paid would be nondeductible, thus eliminating the necessity for annual filings and circular computations. These proposals generally would be effective for decedents dying after 1997, but estates already taking advantage of the installment payment plan would be given a one-time opportunity to convert to the lower nondeductible interest rate in order to simplify their filing requirements.

Empowering Communities and the Economically Disadvantaged

The budget contains proposals to spur private-sector participation in revitalizing distressed communities and to generate job opportunities for long-term welfare recipients.

Tax Incentives to Clean Up Blighted "Brownfields" in Distressed Areas. To encourage companies to clean up abandoned, contaminated industrial properties located in distressed communities, clean-up costs associated with the abatement or control of certain pollutants would be immediately deductible if incurred for a qualified site. Qualified sites include business or income-producing properties located in specified high-poverty areas where it has been certified that hazardous substances are present or potentially present in the property. The deduction would be subject to recapture as ordinary income upon a subsequent disposition of the property at a gain. The proposal would apply to expenses incurred after the date of enactment.

This incentive is expected to leverage $10 billion in private investment to help bring an estimated 30,000 environmentally contaminated industrial sites back into productive use again, helping to rebuild neighborhoods, create jobs, and restore hope to our nation's cities and distressed rural areas.

Additional Empowerment Zones and Enterprise Communities. The Empowerment Zone and Enterprise Community Program would be strengthened by a second round of designations and a new mix of federal tax incentives. The program rewards communities that develop comprehensive strategic plans for revitalizing their neighborhoods with a wide array of community partners. In the first round of designations announced in December 1994, 105 communities were selected.

Under the budget proposal, the Secretary of Housing and Urban Development would be authorized to designate two urban empowerment zones in addition to the six urban and three rural zones designated on December 21, 1994. This would have the effect of extending the current empowerment zone tax incentives to these additional areas, with technical modifications. In addition, 20 additional empowerment zones and 80 additional enterprise communities, which would be subject to modified eligibility criteria, would be authorized. Among the 20 zones, 15 would be in urban areas and five would be in rural areas. The 80 communities would be divided between 50 urban areas and 30 rural areas. Areas within Indian reservations would be eligible for designation.

These additional 20 zones would have available a different combination of tax incentives than those available to existing zones and would include the brownfields initiative, a current deduction for acquisitions of certain business assets, and an expanded form of tax-exempt financing. In addition, the investment incentives available in the original EZs and ECs would be strengthened.

Tax Credits for Community-Oriented Equity Investments. Under the budget plan, access to capital in distressed communities would be enhanced through a new tax credit for equity investments in Community Development Financial Institutions (CDFIs). The Community Development Banking and Financial Institutions Act of 1994 created the Community Development Financial Institutions (CDFI) Fund to provide equity investments, grants, loans, and technical assistance to financial institutions that have community development as their primary mission.

The budget would make $100 million in nonrefundable tax credits available to the CDFI Fund to allocate among equity investors between 1997 and 2006. The allocation of credits is capped at 25 percent of the amount invested in any project and would be determined by the CDFI Fund using a competitive process. Over time, this incentive is estimated to result in at least $5 billion of new lending and investing in distressed urban and rural communities.

Tax Credits to Facilitate the Transition from Welfare to Work. The goal of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 is to move individuals from welfare to work. However, it is anticipated that the process of moving some welfare recipients to work will be a difficult challenge for a variety of reasons, including a recipient's lack of prior work experience and skills relevant to the demands of a changing labor market. To encourage the hiring of these welfare recipients, the President proposes a new welfare-to-work credit that would enable employers to claim a 50-percent credit on the first $10,000 of annual wages paid to certain long-term family assistance recipients[3] for up to two years. Thus, the maximum credit would be $5,000 per year. The new tax credit would be effective through September 30, 2000.

In 1996, the Congress replaced the Targeted Jobs Tax Credit with a work opportunity tax credit (WOTC) of 35 percent of qualified wages paid to a targeted group during the first year of employment, up to a maximum credit of $2,100 per qualified employee. The WOTC expires after September 30, 1997. The President proposes to extend the WOTC for an additional year. Moreover, a new category of qualified employees would be added to the targeted groups. Under the President's proposal, the WOTC would be allowed to taxpayers who hire certain food stamp recipients (*i.e.*, able-bodied adults age 18-50 who, under the Administration’s Food Stamp proposal, would face a more rigorous work requirement in order to continue receiving Food Stamps). The credit for this group would be effective for individuals hired from the date of enactment through September 30, 2000.

Other Tax Relief Provisions

Extension of Other Expiring Tax Provisions. The budget would extend each of the following provisions for one year from their current expiration date:

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[3] "Long-term family assistance recipients" would be defined to include: (1) members of families that have received family assistance (AFDC or its successor program) for at least 18 consecutive months ending on the hiring date; (2) members of families that have received family assistance for a total of at least 18 months beginning on the date of enactment, provided that they are hired within two years of the date that the 18-month total is reached; and (3) members of families who are no longer eligible for family assistance because of Federal or state time limits, provided that they are hired within two years of the date that they became ineligible for family assistance.

- The 20-percent credit for research and experimentation expenditures (expiring May 31, 1997);

- The 50-percent credit for qualified clinical testing of certain drugs for rare diseases or conditions (known as "orphan drugs") (expiring May 31, 1997); and

- The fair-market-value deduction allowed for contributions of appreciated stock to private foundations (expiring May 31, 1997).

Equitable Tolling of the Statute of Limitations. To ensure that disabled persons are treated fairly when filing for tax refunds, the statute of limitations for refunds from the Internal Revenue Service would be delayed when the individual is under a sufficient medically determined disability and no other person has been authorized to act on the taxpayer's behalf in financial matters. The proposal would be effective for taxable years ending after the date of enactment.

Tax Incentive for Economic Development of Puerto Rico. To provide a more efficient and effective tax incentive for the economic development of Puerto Rico, the budget proposes to modify the Puerto Rican economic-activity credit -- basically a wage credit -- by extending it indefinitely, opening it to newly established business operations, and removing the income cap. The budget proposal will address a real need to preserve and create jobs for U.S. citizens in Puerto Rico.

Allow Foreign Sales Corporation Benefits for Computer Software Licenses. The foreign sales corporation (FSC) provisions, which provide a limited exemption from U.S. tax for income arising in certain export transactions, currently are applicable to exports of films, tapes, records, and similar reproductions. Since computer software is similar to these other types of property, we believe that FSC benefits should be extended by legislation to licenses of computer software.

Tax Incentives for Economic Development of the District of Columbia. The budget also includes a package of Federal income tax incentives designed to encourage hiring and increased investment in undeveloped and underutilized areas in the District of Columbia. We are still finalizing the details of this proposal and are discussing the economic development needs of the District with interested business and community leaders. Thus, the specific details of the incentives will be released shortly together with the other components of the President's plan to revitalize the District as the Nation's capital and to improve the prospects of success for home rule. To a large extent, the District tax incentives build on the Administration's Empowerment Zone and Enterprise Community incentives, the Work Opportunity Tax credit, and the President's proposed Welfare-to-Work incentive. Also included in the mix are substantial amounts of tax credits specifically designed to increase the availability of debt and equity capital for those projects in the District that are determined, at the local level, to promote increased economic activity most effectively.

The IRS will assume responsibility from the District of Columbia for administering the District's individual income taxes and unemployment insurance taxes, funded by an addition to the IRS appropriation for that purpose. As a condition of this change, specific authorizing legislation setting out the functions and timing will be required. The IRS will be responsible for management, tax return and refund processing, customer service, computer operations, compliance and enforcement, and will have all of its current enforcement powers available to it.

Closing Corporate Tax Loopholes and Other Revenue Measures

The budget includes measures previously proposed by the Administration to eliminate unwarranted corporate tax subsidies, close tax loopholes that are not economically sound, and improve tax compliance. Such measures include:

- Proposals focused on financial products, to maintain the distinction between debt and equity, to curtail arbitrage opportunities, to prevent avoidance of gain recognition on functional sales, and to measure income properly;

- Proposals focused on corporate transactions, to prevent tax-free disguised sales of businesses, to prevent the manipulation of the stock redemption rules to distort income, to eliminate the use of inventory methods that mismeasure income, and to reduce corporate subsidies such as percentage depletion on lands received from the Federal government at a bargain price;

- Proposals focused on the international tax rules, to measure export income more accurately, to prevent manipulation of the foreign tax credit rules through artificial labels, and to eliminate distortions resulting from the use of derivative financial instruments; and

- Proposals focused on increasing tax compliance, for example by tightening the substantial understatement penalty for very large corporations, expanding withholding on gambling winnings, and streamlining debt collection procedures for non-means tested, recurring Federal payments.

Extension of Expired Excise and Other Trust Fund Taxes. The budget also proposes reinstating the excise and other trust fund taxes that have expired: the Airport and Airways Trust Fund excise taxes;[4] the Hazardous Substance Superfund Trust Fund excise and income taxes; the Oil Spill Liability Trust Fund excise taxes; and the Leaking Underground Storage Tank Trust Fund excise tax. These are not new taxes: they have been applied for years to finance specific programs, such as the provision of air traffic control services and the

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[4] The Administration will propose legislation to completely replace these taxes, effective October 1, 1998, with cost-based user fees, as part of the Administration's effort to create a more business-like Federal Aviation Administration.

cleanup of certain hazardous waste sites. Each of these taxes would be extended through 2007.

<u>Tax Simplification and Taxpayers' Rights</u>

The Administration continues to support revenue-neutral initiatives designed to promote sensible and equitable administration of the tax laws, including simplification, technical corrections, compliance, and taxpayers' rights measures. In the near future, the Administration will propose to Congress a package of such measures.

Conclusion

In conclusion, the President's FY 1998 budget plan proposes to reach balance by 2002 with prudent tax reductions that are pro-family, pro-education, and pro-economic growth, and that are targeted to those who need them the most, with an emphasis on stopping abuses and simplifying the tax system. We look forward to working with the Committee on these proposals. I would be pleased to answer any questions that you might have.